BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CHARLES HARLEY COMPANY)

Appearances:

For Appellant: F. F. McClintock, Assistant Secretary and Controller of said corporation; Gregory A. Harrison for Messrs. Brobeck, Phleger & Harrison, its Attorneys

For Respondent: Frank L. Guerena, his Attorney

O P I N I O N

This is an appeal pursuant to Section 25 of the California Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929), from the action of the Franchise Tax Commissioner in overruling the protest of Chales Harley Company against a proposed assessment of an additional tax *in* the amount of $465.44, based upon its return for the fiscal year ended April 30,1929.

The sole point on appeal is whether the entire income of the Appellant is taxable as arising from California business or whether an allocation should be made under Section 10 of the Act on the ground that a part of income is attributable to business done without the state. The Appellant is a California corporation dealing as a wholesaler in waste materials. A great many of its sales are made to customers outside of California, but we believe that practically all of these must be regarded as interstate commerce between California and the states where these customers are. While contracts are made and orders taken for the delivery of goods outside of this State, the shipments are sent from California so that the business is of an interstate character. (Real Silk Hosiery Mills, Inc. v. Portland, 268 U. S. 325.)

However, from a schedule submitted by the Appellant it appears that some sales were made "without the state of merchandise purchased elsewhere and never shipped into the State of California". We do not believe that these sales could be regard as business done within this State, and think that because of them the Appellant is entitled to an allocation of some of its net income to nontaxable status. We are not impressed with the proposition advanced by the Commissioner that

> "A corporation which maintains an office or place of business within the state, and not elsewhere, is taxable *on* the basis of all of its net income as defined by the Franchise Tax Act."

Appeal of Charles Harley Company

In our opinion filed today in the matter of the Appeal of Great Western Electro Chemical Company we discussed the fallacies involved in such a proposition, and for the reasons there assigned we think it is untenable.

'Under the doctrine of the case of United States Glue Company v. Oak Creek, 153 N.W. 24, 247 U. S. 321, from which we quoted at some length in the Great Western Electro Chemical matter, supra, we conclude that all of the interstate business of the Appellant such as is described in the second paragraph of this opinion, represents California activity, so that all income arising therefrom is taxable here; we further conclude that, since the Appellant has sold'some merchandise outside of the state, purchased elsewhere and never shipped here, it was, to that extent, doing business without California.

This conclusion gives rise to the question of the allocation formula to be used in the apportionment of net income between California business and out-of-the-state business. In the form for the taxpayer's return, prescribed by the Commissioner under Section 13 of the Act, three factors are indicated under the heading "Allocation of Income". These are:

1. Average value (actual) of real and tangible personal property.

2. Wages, salaries, commissions and other compensation of employees.

3. Gross sales.

There are five factors specifically enumerated in Section 10 of the Act. The Commissioner used three of these in the form prescribed by him. The other two are:

4. Purchases.

5. Expenses of manufacture.

However, as we observed in our opinions in the matters of appeals of Pacific-Burt Company, Limited, (filed August 4, 1930) and R. J. Reynolds Tobacco Company (filed January 19, 1931), no taxpayer has an absolute right to have its net income allocated upon the basis of the five factors. If the use of the three factors of tangible property, payroll and sales is standardized upon the form for report and proves satisfactory in most cases, we think that any corporation asking for the application of a different formula to its income must show convincingly the necessity therefor. There is nothing before us in the instant case from which we should conclude that use of the standard formula operates unfairly in respect to the income of the Appellant.

It is true that the Appellant has listed a number of out-of-state purchases in a schedule attached to its memorandum on appeal, but no mention has been made of purchases in the state from which we could determine the relative importance Of the two types of transactions. Judging from the value of merchandise bought for sale as appearing in the schedule of gross income included in the return of the taxpayer, the Out-of-state. purchases must be a comparatively unimportant element in its business. Doubtless, many California concerns make out-of-stat6 purchases to the same extent, and have reported to the Commissioner without claiming any allocation of income on account thereof. There does not seem to be any real injustice to Appellant through the use of a formula which excludes purchases as a specific factor.

We are impressed, however, with the suggestion that the manner in which the schedule for "Allocation of Income" has been prescribed by the Commissioner has caused numerous corporations to show as out-of-state income, the same type of income as this taxpayer is now required to return as taxable. After enumerating the three factors already mentioned, the form contains three columns for the entry of sums of money opposite these factors. These columns are designated thus:

(a) Total within and without the state.
(b) Total within the state.
(c) Per centum within the state.

There is no explanation given of what constitutes a sale "within the state" and it is obvious that in most cases, as in this, the taxpayer would interpret sales "within the state" to mean those sales actually made to California customers, It is too much to expect that the average taxpayer would have included, without special instructions so to do, as sales within the state, transactions had in interstate commerce with customers outside of California. We are reliably informed that numerous taxpayers construed the form to call for the listing as "within the state" of only those sales made to California customers.

When this was done by a corporation which maintained an office outside of California, and so was entitled to claim allocation under the Commissioner's "Test", it is extremely doubtful if the discrepancy would be detected by him. Thus, the allocation permitted that corporation would be distorted in its favor through allowance of much larger factor for out-of-state sales than it would be entitled to under the correct interpretation of the law. It is unfortunate that such a condition should have existed, and that corporations with no offices outside of the state should thus be the object of discrimination. However, these circumstances would not justify us in departing from the legal principles established in cases to which we have referred. We must adhere to the conclusion that all sales made in interstate commerce from stocks in this state constitute California business.

In conformity with this view we believe that the allocation of the Appellant's gross sales should exclude from the classification "within the state" the $37,832.49 derived from sales without the state of merchandise purchased elsewhere and never shipped into this state. Otherwise, all sales should be classified as having been made here. On this basis the percentage of sales within the state would be 98.1206. Since the other two factors prescribed by the form were 100% within the state, the average of the three would be 99.3735%. Application of this percentage to the Appellant's net income for state purposes (item 38 of the return) will yield $60,661.22.

Calculation of the tax would be as follows:

Item 40--Net income allocated to state	$60,661.22
Item 41--Four per cent	2,426.45
Item 42--Offset allowance	796.10
Item 43--Tax after offset allowance	$ 1,630.35
Item 44--Add four per cent of offset	31.84
Item 45--Total Tax	$ 1,662.19
Self Assessed	1,212.04
Additional Tax	$ 450.15

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the action of the Franchise Tax Commissioner in overruling the protest of Charles Harley Company, a corporation, to his proposed assessment of an additional tax against said corporation under Chapter 13, Statutes of 1929, in the amount of $465.44, based upon the return of said corporation for the year ended April 30, 1929, be and the same is hereby modified to the end that the correct amount of the tax due from said corporation is determined as $1,662.19 and the additional tax to be paid is fixed at $450.15

Done at Sacramento, California, this 14th day of December, 1931, by the State Board of Equalization.

Jno. C, Corbett, Chairman
R. E. Collins, Member
H. G. Cattell, Member
Fred E. Stewart, Member

ATTEST: Dixwell L. Pierce, Secretary